The Stock Market in Transition

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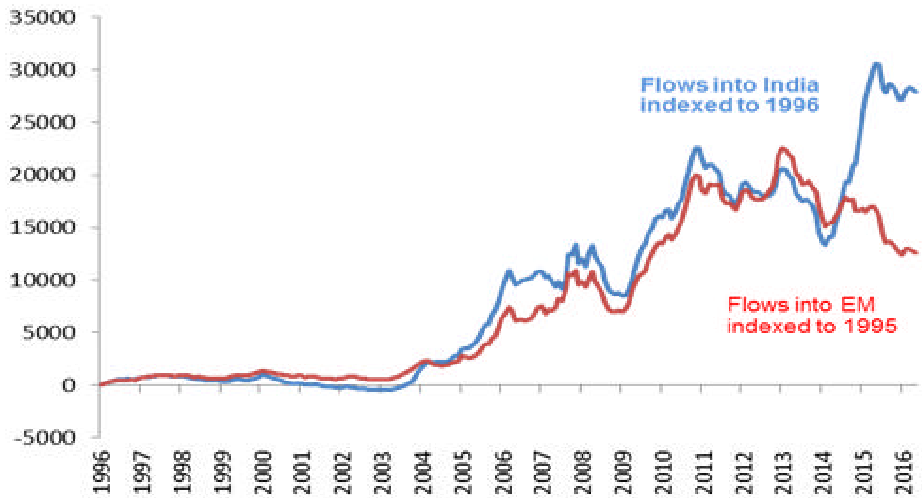
Summary

India's relative valuations are close to an all-time peak. How sustainable is this? Five things are driving India's re-rating: 1) Improved terms of trade - track commodity prices; 2) a belief that India has superior medium term growth - track India's policy actions; 3) positive real rates not driven by deflation but due to positive interest rates - track inflation and monetary policy; 4) structural shift in domestic saving into equities - domestic mutual fund flows is a good indicator to follow; 5) shift in macro funding from FPI to FDI - again data available regularly. The concomitant impacts are: a) lower correlation with EM - thus India is like a hedge in the EM world; and b) lower absolute volatility for Indian shares. Re-rating stories are always to be caveated because in the end higher share prices can only be accounted for by higher earnings. So unless India sustainably beats its peer group in earnings terms, its premium valuations will mean revert. The test begins now.

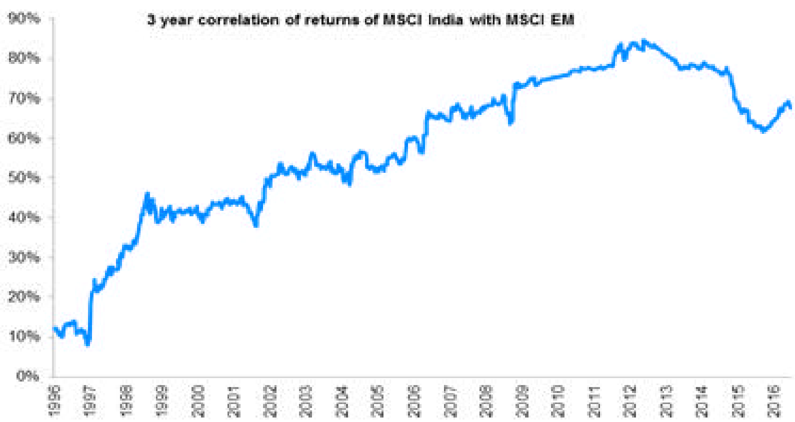
The Transition – Losing EM Membership?

Exhibit 1: India vs. EM: FPI Flows Diverging Significantly



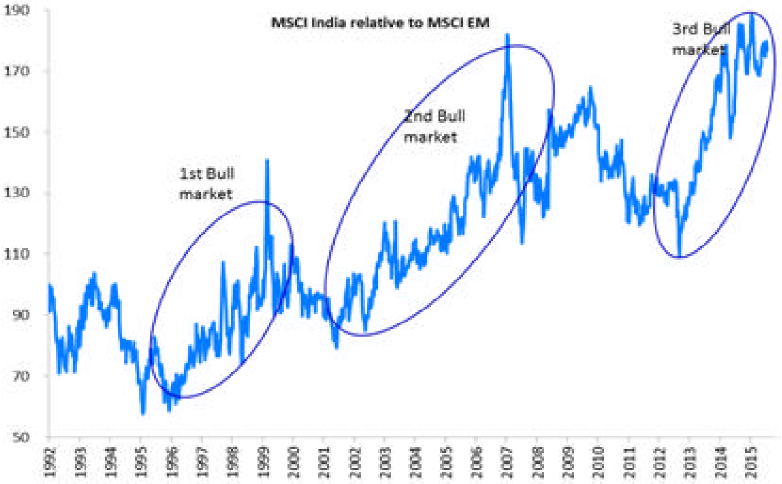
Source: EPFR, Morgan Stanley Research

Exhibit 2: India's Correlation vs. EM: Falling since 2013



Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 3: India in the midst of its Third Bull Market Relative to EM



Source: RIMES, Morgan Stanley Research

India's equity saving has declined on a secular basis since the mid-90s. By 2013, financial saving had dropped to the pre-1991 crisis level. The persistent decline in domestic equity saving meant that India experienced an exponential rise in its consumption of global risk capital relative to domestic saving in risky assets. From around 0.5x, in the mid-1990s the ratio rose to in excess of 20x by the time the global financial crisis arrived. The consequence of dependence on global risk capital in lieu of domestic risk capital formation meant that Indian equities have been exposed to global capital market cycles since 1995.

If one goes back 20 years, India's FPI flows have been tightly correlated to EM flows (Exhibit1). In fact, save for three episodes in the past 15 years, the three-year correlation of flows between India and EM has been close to 1. The three episodes are: May 2004, when India produced a completely out-of-consensus election result; 2007-08, when India received excessive flows and then suffered the brunt of the credit crisis; and briefly in the summer of 2013, when India's economy was in poor shape and got exposed as the Fed threatened to taper.

The over reliance on global capital market flows and the membership of the EM block brought volatility to Indian equities far in excess of the variance in the underlying fundamentals. For example, India has exhibited significantly higher stock market index volatility relative to earnings volatility. Indeed, the ratio was over 3 for the past two decades – more than 3 times the average for emerging markets and more than 5 times the average for the developed world.

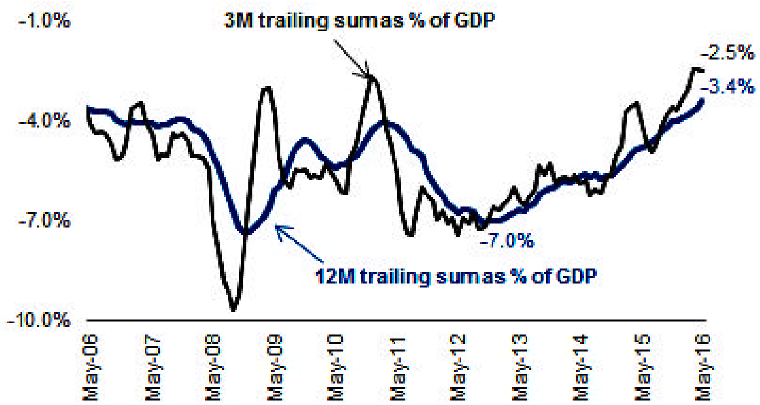
In 2013, India was suffering from a high fiscal deficit caused in part by excessive government consumption expenditure and from persistent negative real rates concomitant with a wide current account deficit and persistent double-digit CPI. The summer scare led by the Fed's threat to taper its quantitative easing program served as a catalyst for change. Real rates were taken higher, the new government instilled significant fiscal discipline and, as oil prices fell, India's macro registered a shift. It set the stage for a meaningful delta in India's correlations with emerging markets. Further India experienced a flux in policy – FDI opened up, infrastructure execution improved and a general improvement in ease of doing business took place.

Two things have changed for India since the middle of 2013: a) growth is sparse in the world – in contrast, India offers superior absolute and relative growth optionality; and b) India seems less dependent on global capital market flows due to better macro stability whereas domestic financial saving is rising and FDI is meaningfully higher.

India now seems to be decoupling from EM, or to put it more appropriately, its beta to EM has been falling . Thus, over the past three years, India has underperformed EM rallies and outperformed falling EM indices. The separation of India from the EM basket is evident in the correlation of returns between the two (Exhibit 2). The result of this breakdown is that India is in the midst of its third bull market relative to emerging markets. This bull market which began in Sep-13 is now in its 150th week and has generated 65% outperformance for India in US$ terms versus emerging markets (Exhibit 3). As we mention earlier, the reasons for this separation and outperformance are embedded in India's policy actions and India's structural growth story.

The Structural Growth Story and The Cyclical Repair

Exhibit 4: Commodities Trade Balance at a Low Point

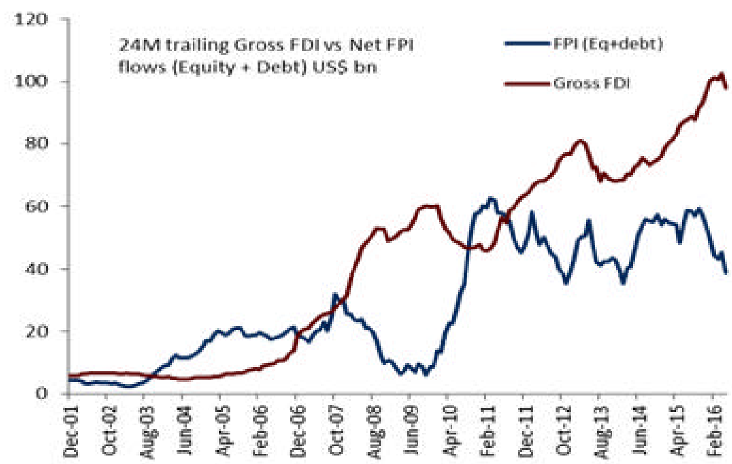


Source: CEIC, Morgan Stanley Research

India enjoys better demographics, low overall debt to GDP and lack of secular deflation pressures. The three Ds of demographics (aging population), debt (global debt to GDP has risen since the 2008 crisis instead of declining) and deflation (due to excess capacity) are haunting the world. There are very few places on the planet which do not face these challenges. India is one of them. This sets India apart and is the fundamental reason for India's apparent decoupling. India's debt to GDP is virtually unchanged since the global financial crisis albeit there has been a shift in the mix from the government to the private sector. India has nudged out of 17 successive months of PPI deflation although the recovery in PPI inflation is fragile. Demographics is an advantage so far as India can skill its burgeoning work force. All this said, India has the choices which the world does not have. With a proper policy response India can deliver long term growth much higher than the world.

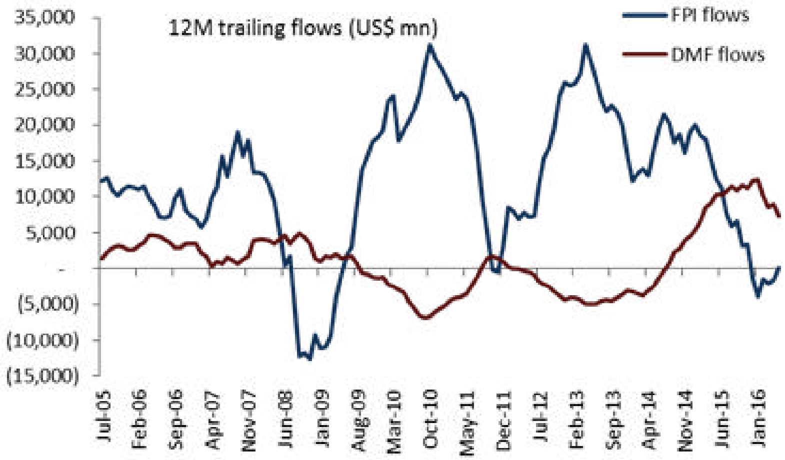
There are cyclical reasons too. Since the new government has come to office, India has experienced improved macro stability and a shift in funding mix. Consequent to fiscal consolidation and positive real rates and their concomitant effect on inflation, financial saving is higher. Equity saving, in particular, has benefited and the ratio of FPI to domestic saving in equity has collapsed. The tail wind of falling commodity prices – which has hurt EM concurrently – has added to the mix (Exhibit 4).

Exhibit 5: Dramatic shift in FDI to FPI Ratio



Source: CEIC, SEBI, Morgan Stanley Research

Exhibit 6: A New Source of Demand for Indian Equities



Source: SEBI, Morgan Stanley Research

In addition, the government has opened up foreign direct investments across various sectors. Pertinently, corporate boards around the world have expressed belief in the Prime Minister's plans for India and are committing capital to India almost like never before.

Due to the changes in FDI limits and India's better relative growth, FDI itself has surged. The ratio of FDI to FPI has undergone a dramatic alteration (Exhibit 5). This has made India less susceptible to global capital market cycles unlike the past.

Better macro stability as a result of higher saving (from government and households) implies India's need for external capital has fallen. As a country's need for external flows drops, external flows actually tend to rise. So India has run up a positive BoP since the end of 2013.

Domestic saving, especially equity saving is higher. This means that the ratio of FPI to domestic equity flows is lower (Exhibit 6). We see a structural change on domestic equity saving.

Structural Liquidity Unfolding

The scars from losses made in the early 1990s when equities were popular among the Indian retail fraternity have faded, in our view. A new generation is looking at equities. With regulations and demographics now more favorable for investors, investor education having increased, and a less risk averse population, the qualitative environment favors equity investing. From a fundamental perspective, positive real rates and rising trailing returns boost the case for equity investing by domestic households. Our view that growth is likely to revert to trend in the coming months and that long term equity valuations are attractive further enhances the case for an increase in equity flows from Indian households. Our estimate (using simple linear models) is for a domestic flow of US$300bn over the coming 10 years versus the US$50bn and US$134bn that households and FIIs invested over the previous 10 years.

The recent evidence is that households have started raising equity exposure with a discernable increase in systematic investing. This is not surprising since some of the catalysts we cite, namely trailing equity returns and positive real rates, are in play already. For these flows to continue in the coming months, it is important that earnings growth recovers since growth is the overarching factor influencing equity returns.

The End Game

Two conclusions to note: 1) volatility in Indian share prices that has thus far significantly exceeded volatility in earnings will likely decline as the equity market's dependence on foreign flows reduces; 2) a new source of demand for Indian equities implies higher multiples for shares and/or greater appetite for equity supply.

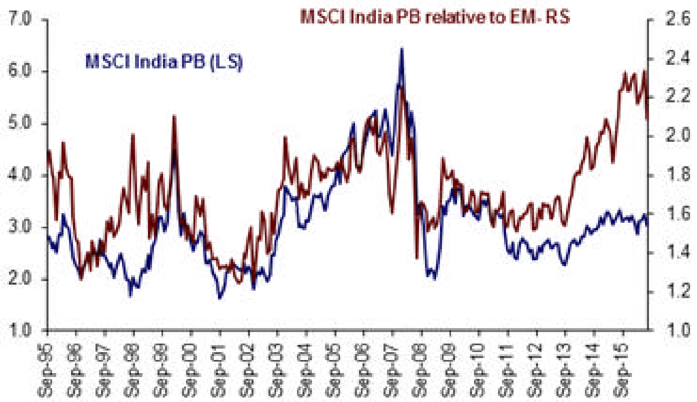
For India to retain these low correlations, it becomes imperative that its policy makers smoothly transition from focusing on macro stability to pursuing growth. If such a transition proves illusory, correlations will mean revert. However, if India lifts growth, it is quite possible that its equity market may retain this newly acquired low beta characteristic for a considerable length of time.

The Case for India's Premium Valuations

The same logic applies to India's premium valuations. If we are in a low return (read: low growth) world, Indian shares will likely continue to command premium valuations because its own nominal growth will likely be higher. We say this with great reluctance but are not oblivious to India's case.

The value of an equity share is the present value of future dividends from the share discounted using the investor's expected return. A low return world means a lower discount rate (i.e., expected returns are lower). Of course, a low return world also signals lower future nominal growth in dividends. For most parts of the world, this means that the fair value of share is lower than before. For India, the implications may be more favorable. Indeed, India's nominal growth should still hold up (helped by demographic, debt and deflation dynamics relative to the world and assuming no bungling in policy) and the world is seeking a lower return which means the value of Indian shares rises relative to most parts of the world. In turn, this implies India trades at premium valuations to its peer group. This story has been in play for India over the past few quarters ever since prospects of a new political leadership emerged in late 2013 and commodity prices started to fall. That said, at some point in time part of these rich relative multiples will decline (either because world growth prospects improve, commodity prices rise and/or policy mix deteriorates). Bottom line for investors is that they need to lower both medium term growth and terminal growth while cutting their expected returns from equities (a lower equity risk premium) when debating investment calls at the stock level.

Exhibit 7: India's PB premium at record levels



Source: RIMES, MSCI, Morgan Stanley Research

Caveat Emptor

India's relative multiple to emerging markets has had its cycles. For most of the 1990s and the start of the previous decade, India traded at a discount to emerging markets. The 2004-08 bull market changed that albeit arguably it was to do with how India's potential growth rate rose relative to the rest of EM due to its own factors.

In the aftermath of the credit crisis, India's relative multiples declined to just above its pre-2003 level. In the past three years, the premium has once again risen to record highs (Exhibit 7) - helped by all the factors listed earlier but essentially due to India's rising relative growth prospects.

A side note is that for the first time the rise in India's relative multiple is not accompanied by a similar lift in its absolute multiples. For investors at home equities do not look so rich versus history and for investors abroad they are actually grappling with the broken denominator (read: EM) in India's relative multiple. The expansion in relative valuations has not yet been accompanied by superior earnings growth but alludes to a view that India's future earnings growth will be superior. Whether it is or not will determine how much of India's premium stays.